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**Before the**
**FEDERAL COMMUNICATIONS COMMISSION**
**Washington, D.C. 20554**

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| In the Matter of | ) | |
| | ) | |
| Regulatory Reform for Local Exchange | ) | CC Docket No. 92-135 |
| Carriers Subject to Rate of Return Regulation | ) | |

## ORDER ON RECONSIDERATION

Adopted: February 10, 1997 Released: February 18, 1997

By the Commission:

## I. INTRODUCTION

1. On June 11, 1993, the Commission adopted new rules to implement regulatory reform for small and mid-size local exchange carriers (LECs) that remain subject to rate-of-return regulation.[1] These rules incorporated a new optional incentive-based plan[2] and expanded the scope of the small company rules[3] to allow simplified tariff filing procedures for traffic sensitive rates and common line rates.[4] We also amended our rules to permit carriers that do not elect to participate in the incentive plan or the small company rules to file access tariffs every two years.[5]

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[1] Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, Report and Order, CC Docket No. 92-135, 8 FCC Rcd 4545 (1993) (*Small Telco Reform Order*). *See* ¶ 5 nn.23, 24, *infra*, for definitions of small and mid-sized companies.

[2] *See* 47 C.F.R. § 61.50. These new regulations give a LEC the potential for greater efficiencies and higher earnings by permitting it to establish rates based on historical costs rather than on the prospective cost-plus basis of classic rate of return regulation. The incentive plan also permits limited pricing flexibility and streamlined treatment for the introduction of new services in some situations.

[3] *See* 47 C.F.R. § 61.39.

[4] These revisions allow LECs serving 50,000 or fewer access lines to file annual common line rates based on their historical costs.

[5] *See* 47 C.F.R. § 69.3(a).

2. American Telephone and Telegraph Company[6] (AT&T) filed a petition for clarification or, alternatively, for reconsideration of the *Small Telco Reform Order*. The National Exchange Carrier Association (NECA) filed a petition for reconsideration and the United States Telephone Association (USTA) filed a petition for partial reconsideration and clarification.[7]

3. Petitioners seek reconsideration of several issues addressed in the *Small Telco Reform Order*. USTA and NECA request that we reduce the two year notice period that LECs must provide before exiting the incentive plan, and NECA argues that the prohibition against reentry into the pools[8] violates pool neutrality and the voluntary nature of pools.[9] AT&T seeks reconsideration of the provision in the incentive plan that allows LECs rate adjustments of 10% within each service category over each two-year tariff period, because AT&T believes the rule could be interpreted to allow LECs using the incentive plan to recover 110% of their costs.[10] USTA also requests that the incentive plan's streamlined filing requirements for new services be extended to apply to new services in territories where the "geographically closest" (but not bordering) price cap LEC offers the same service.[11] Finally, USTA requests that we delete the infrastructure reporting requirements for the incentive plan, arguing that such reports are not required for voluntary price cap LECs and so should not be required for incentive plan LECs.[12] In response to these requests for revisions, we eliminate the two-year exit notice requirement and suspend the infrastructure reporting requirement, but otherwise decline to make the requested revisions to the *Small Telco Reform Order*.

4. The petitioners also seek clarification of several issues contained in the *Small Telco Reform Order*. USTA and AT&T argue that the rules embodying the common line rate structures for the incentive plan and small company rules are inconsistent with the text of the *Small Telco Reform Order*, and should be clarified. We believe that the rules are consistent with the order, but nonetheless we have redrafted the rules as formulae to eliminate any inconsistencies in the order's application.[13] USTA requests that we add a clarifying statement concerning the relative

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[6] Now AT&T, Inc.

[7] USTA subsequently filed additional comments on the AT&T and NECA petitions.

[8] *See* ¶ 6 n.25, *infra*, for a definition of the NECA "pools."

[9] *See* ¶¶ 12-21, *infra*.

[10] *See* ¶¶ 22-25, *infra*.

[11] *See* ¶¶ 26-30, *infra*.

[12] *See* ¶¶ 31-33, *infra*.

[13] *See* ¶¶ 34-38, *infra*.

burdens on incentive plan participants that seek to increase their rates by making mid-term corrections to their tariffs. On this matter we believe the *Small Telco Reform Order* is clear and deny USTA's request.[14] USTA also requests that we codify the incentive plan's mechanism for exogenous cost adjustment. We agree with USTA and amend our rules to codify the *Small Telco Reform Order*'s provision that incentive plan LECs may adjust their rates (either in the biennial tariff filing or during the two-year tariff period) to reflect exogenous cost changes for costs deemed exogenous for price cap LECs.[15] Finally, USTA requests that to remove potential ambiguities, we should make certain minor, non-substantive revisions to the sections of the *Small Telco Reform Order* concerning voluntary biennial filings,[16] the base period for end user common line calculations,[17] and rate change indexes.[18] This order amends the *Small Telco Reform Order* to clarify those matters.

## II. BACKGROUND

5. In the *LEC Price Cap Order*,[19] the Commission required the seven Regional Bell Operating Companies (RBOCs) and the General Telephone Operating Companies (GTOCs) to file interstate access rates based on our incentive-based scheme of regulation called price cap regulation.[20] Under the *LEC Price Cap Order*, all other carriers may elect to file rates based on

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14 *See* ¶¶ 39-42, *infra*.

15 *See* ¶¶ 43-44, *infra*.

16 47 C.F.R. § 69.3(b); *see* ¶¶ 45-46, *infra*.

17 47 C.F.R. § 61.50; *see* ¶ 47, *infra*.

18 47 C.F.R. § 61.50(h)(1); *see* ¶ 48, *infra*.

19 *See* Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786, 6818 (1990) (*LEC Price Cap Order*), *Erratum*, 5 FCC Rcd 7664 (1990) (Com.Car.Bur.), *modified on recon*, 6 FCC Rcd 2637 (1991) (*LEC Reconsideration Order*), *aff'd*, *National Rural Telecom Association v. FCC*, 988 F.2d 174 (D.C. Cir. 1993).

20 The price cap plan the Commission adopted in the *LEC Price Cap Order* is designed to mirror the incentives for efficiency found in competitive markets, thus acting as a transitional regulatory scheme until the advent of actual competition makes price cap regulation unnecessary. The plan achieves its purpose by encouraging LECs to move prices for interstate access services to economically efficient levels, to reduce costs, to invest efficiently in new plant and facilities, and to develop and deploy innovative service offerings. Under the existing plan, price cap indexes limit the maximum prices that LECs may charge for their interstate services. The indexes are adjusted each year in accordance with a formula that accounts for industry-wide changes in unit costs. The price cap plan rewards LECs that exceed the productivity target by permitting them to retain higher profits than they would be allowed to retain under rate-of-return regulation. *See* Price Cap Performance Review for Local Exchange Carriers, First Report and Order, 10 FCC Rcd 8961, 8965 (1995) (*Price Cap Performance Review*).

price cap regulation, but once they have chosen price caps they may not later return to rate-of-return regulation.[21] Currently, the LECs operating under interstate price cap regulation account for approximately 90% of the total interstate revenues for access services.[22] The LECs that remain subject to rate-of-return regulation are mainly small[23] and mid-size[24] companies.

6. Almost all of the LECs subject to rate-of-return regulation participate in the traffic sensitive and common line pools administered by NECA (although not all of these LECs participate in both the common line and traffic sensitive pools).[25] Recognizing the varied conditions and characteristics of small and mid-size LECs, the Commission permitted those companies the option to remain under rate-of-return regulation or to enroll in price caps.[26] The Commission also indicated that it would explore ways to adapt the price cap efficiency incentives to the needs of small and mid-size LECs.[27]

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[21] *LEC Price Cap Order*, 5 FCC Rcd at 6819.

[22] *See* 1996 Annual Access Tariff Filings, Memorandum Opinion and Order, 11 FCC Rcd 7564, DA 96-1022 (rel. June 24, 1996), erratum, 11 FCC Rcd 11979 (rel. June 27, 1996) (*1996 Annual Access Order*). The LECs presently subject to price cap regulation include the Bell Operating Companies (BOCs), GTE (including GTE Telephone Operating Companies (GTOCs) and GTE System Telephone Companies (GSTCs), Frontier Communications of Minnesota and Frontier Communications of Iowa (Frontier), Lincoln Telephone Company (Aliant Communication Company as of September 1, 1996), Rochester Telephone Corporation (Rochester), Southern New England Telephone Company (SNET), and Sprint Local Telephone Companies (Sprint LTCs). *Id.*

[23] Small companies are defined as those carriers with fewer than 50,000 access lines that also are part of NECA Subset 3, as defined by Section 69.602(a)(3) of the rules, 47 C.F.R. § 69.602(a)(3). *See* Regulation of Small Telephone Companies, Report and Order, CC Docket No. 86-467, 2 FCC Rcd 3811, 3812 (1987) (*Small Companies Order*).

[24] The mid-size companies, with between 50,000 and approximately 1 million access lines, generally have multiple telephone company subsidiaries. The stock of larger mid-size companies is often publicly traded. Most of these companies operate in more than one state. *See* Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, Notice of Proposed Rulemaking, CC Docket 92-135, 7 FCC Rcd 5023, 5024 (1992) (*Small Telco Reform NPRM*); *Erratum*, 7 FCC Rcd 5501 (1992).

[25] As required by the rules (*see* 47 C.F.R. § 69.601(a)), NECA administers common line and traffic sensitive cost and revenue pools on behalf of over 1,200 LECs, including the vast majority of small and mid-sized telephone companies. The rates in NECA's access tariffs are based on these pooled costs. Participants in the NECA pools avoid the administrative costs and burdens of filing and maintaining their own interstate access tariffs, while reducing their risks and virtually guarantying themselves a steady interstate return.

[26] *LEC Price Cap Order*, 5 FCC Rcd at 6799.

[27] *Id.* at 6827.

7. Small LECs have generally chosen not to become subject to price cap regulation for several reasons. Price cap regulation may not afford small LECs the same risk sharing protection provided by the NECA pools and Long Term Support mechanism, which maintains a common line rate equivalent to a national average common line rate.[28] Small LECs may also be ill-equipped to comply with the annual rate adjustments required by price caps because their business cycles are too long and the financial effect of facility upgrades is too great to be reconciled within the Commission's price cap framework.[29]

8. The *LEC Price Cap Order* stated that the Commission would "initiate further proceedings dealing specifically with regulatory issues of concern to small and mid-size LECs."[30] In that Order, the Commission asserted its commitment to examine regulatory options that "recognize the unique circumstances" facing smaller LECs.[31] Finally, the Order resolved to continue to examine small company issues "to ensure that desirable regulatory reforms are applied to small telephone companies as far as possible and applied with sensitivity to their special circumstances."[32] This docket has been a primary vehicle for implementing the commitment of the *LEC Price Cap Order*.[33]

9. After initiating the *Small Telco Reform NPRM* in this docket,[34] we released the *Small Telco Reform Order*, which adopted optional incentive regulation for small and mid-sized LECs.[35] Essentially, the incentive plan is a form of "lagged" rate-of-return regulation[36] that allows a LEC to earn higher profits if its efficiency during a two-year rate period surpasses its

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28 *See Small Telco Reform Order*, 8 FCC Rcd at 4546.

29 *Id.*

30 *LEC Price Cap Order*, 5 FCC Rcd at 6827.

31 *Id.*

32 *Id.*

33 *See also* Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, Notice of Proposed Rulemaking, 7 FCC Rcd 4688 (1992) (exploring streamlining and improving methods by which authorized rate of return is selected).

34 *See* ¶ 5 n.24, *supra.*

35 *See* ¶ 1 n.1, *supra.* Cincinnati Bell Telephone (CBT) is currently the only participant in the optional incentive regulation plan. *See* Cincinnati Bell Telephone Transmittal No. 668, FCC Tariff No. 35, filed October 4, 1994.

36 The incentive plan is "lagged" because the tariff rates for each upcoming two-year tariff period are linked to each company's historic costs. *See Small Telco Reform Order*, 8 FCC Rcd at 4547.

historical performance. Under the incentive plan, rates are set every two years, based on the LEC's cost for the prior two-year tariff period. At the end of each tariff period, the LEC must retarget its rate levels to the Commission's prescribed rate-of-return by accounting for any decreased costs the LEC may have experienced. The plan sets no specific productivity target, as the price cap scheme does. The carrier is rewarded, however, if its productivity (*i.e.*, actions lowering costs) surpasses that of its prior two-year period because it is allowed to retain any savings as increased profit beyond the authorized rate-of-return. By contrast, a carrier's profit under baseline rate-of-return regulation[37] is limited to the Commission's prescribed rate of return. Under the incentive plan, ratepayers benefit from the carrier's efficiency gains in the form of lower rates in the next rate period when the rates are retargeted to account for decreased costs.

10. While the optional incentive plan offers small and mid-size LECs lower potential rewards than full price caps, it also exposes them to lower risks. For example, under the Commission's current price cap scheme,[38] price cap LECs that elect the lowest productivity factor of 4.0 may earn up to 12.25% before they are required to share[39] excess earnings, (*i.e.*, those above 12.25%) on an equal basis with their customers, and can earn up to 13.25% before having to share 100% of excess earnings.[40] The incentive plan permits LECs to earn up to 1.5% above the prescribed rate of return, currently 11.25%,[41] and incur no sharing obligation.[42] By comparison, carriers subject to baseline rate-of-return regulation may earn only .25% above the prescribed rate of return, on a total interstate basis.[43] Incentive plan LECs also have greater

[37] "Baseline rate-of-return regulation" refers to the Commission's procedures used to review tariffs filed by non-price cap LECs that have not elected either the incentive plan under Section 61.50 of the Commission's rules or the small company rules under Section 61.39 of the rules. Under these procedures, a carrier develops its rates based on projections of cost and demand plus its authorized rate of return.

[38] *See Price Cap Performance Review*, 10 FCC Rcd at 8971.

[39] The sharing mechanism under price caps requires LECs with earnings above the earning zone to "share" a portion of the over-earnings by refunding a portion of the excess to its customers in the form of lower rates. *See Small Telco Reform NPRM*, 7 FCC Rcd at 5025, n. 10.

[40] If the price cap LEC elects the 4.7 productivity factor, the carrier is permitted to earn up to 12.25% before sharing half of the returns, and up to 16.25 percent before 100 percent sharing occurs. LECs that elect the 5.3 productivity rate are not subject to sharing and are not permitted to make low-end adjustments. *Price Cap Performance Review*, 10 FCC Rcd at 9050.

[41] The Common Carrier Bureau has released a Public Notice seeking comment on whether the Commission should commence a represcription proceeding. Common Carrier Bureau Sets Pleading Schedule for Preliminary Rate of Return Inquiry, Public Notice, DA 96-139, 11 FCC Rcd. 3651 (rel. Feb. 21, 1996).

[42] *See Small Telco Reform Order*, 8 FCC Rcd at 4550; 47 C.F.R. § 65.700(d).

[43] *See* 47 C.F.R. § 65.700(b).

flexibility in setting their rates than do carriers operating under rate-of-return regulation, as incentive plan pricing is based on baskets and service categories identical to those employed in price cap regulation.[44]

11. In addition, we expanded the simplified tariff filing options available to small LECs under Section 61.39 of our rules.[45] Those simplified procedures that previously applied only to traffic sensitive rates, *i.e.*, biennial rather than annual tariff filings with rates based on the LEC's historical costs, are now available for carrier common line filings as well.[46] Finally, for LECs that remain under baseline rate-of-return regulation, the Commission reduced their regulatory burdens by requiring biennial rather than annual tariff filings.[47] Collectively, these revisions to our rules governing small and mid-size LECs were designed to assure reasonable rates, reduce regulatory burdens and introduce (or expand) incentives for efficiency and innovation.

## III. DISCUSSION

### A. Issues for Reconsideration

#### 1. Two-Year Notice Requirement and Return to NECA Pools

*Background*

12. In the *Small Telco Reform Order*, we established four years (two tariff periods of two years each) as the minimum period a LEC may elect to participate in the incentive plan. We also required carriers seeking to exit the incentive plan to give the Commission two years notice of their intent to exit. Further, although the election of the incentive plan is not irrevocable, a carrier leaving the plan may not return to the NECA pools. Such carrier may either file its own tariffs under baseline rate-of-return regulation or elect price cap regulation.[48] The Commission found that by requiring a LEC to remain in the plan for a reasonable amount of time and by restricting its choices if it leaves the plan, our rules would create incentives for long term

[44] *See* 47 C.F.R. § 61.50(e). "[B]askets" are "broad groups of LEC services, each subject to its own price cap." *See LEC Price Cap Order*, 5 FCC Rcd at 6811. Service categories are subdivisions of baskets. *Id.*

[45] *See* 47 C.F.R. § 61.39.

[46] *See* 47 C.F.R. §§ 61.39(b)(3), (b)(4).

[47] *See* 47 C.F.R. §§ 69.3(a).

[48] *Small Telco Reform Order*, 8 FCC Rcd at 4555-56.

efficiency, not opportunities for a LEC to "game" the system[49] by realizing short term profits through switching between different regulatory plans.

*Positions of the Parties*

13. USTA argues that the two-year notice period makes it difficult for a carrier to decide whether to leave the plan after the initial two tariff periods. USTA also contends that in no other context does the Commission require LECs to provide notice two years in advance of any LEC action. Finally, USTA asserts that the NPRM gave no indication that the Commission was considering a two-year notice period.[50] Concerning the prohibition from reentering the pools, NECA and USTA argue that the NECA traffic sensitive pool has always been voluntary for non-price cap companies and should remain an option for LECs choosing to leave the incentive plan.[51] NECA also asserts that prohibiting incentive plan carriers from returning to the NECA traffic sensitive pool violates the "need for pooling neutrality" by denying LECs the administrative savings of participating in NECA tariffs.[52]

*Discussion*

14. In creating an incentive-based regulatory alternative to our baseline or "cost-plus" rate-of-return regulation, we have always attempted to create reasonable limits on a participant's ability to "game" the system.[53] In the *LEC Price Cap Order*, for example, we found that price cap regulation would strengthen carriers' incentives to increase their efficiency, which would in turn lead to lower rates.[54] The Commission also concluded that participation in pools inherently entails risk-sharing, and thus weakens a LEC's incentive to operate efficiently. Therefore, the Commission excluded pooling carriers from price caps.[55] Further, the *LEC Price Cap Order* determined that a LEC electing price cap regulation should not have the option to return to rate-of-return regulation because, for the price cap approach to work effectively and for incentives to

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49 *See* ¶ 18, *infra*, for a discussion of gaming.

50 USTA Petition at 7-10.

51 NECA Petition at 3-4; USTA Petition at 6-7; USTA Comments at 1-2.

52 NECA Petition at 3-4; citing the *Small Telco NPRM*, 2 FCC Rcd at 3811. "Pooling neutrality" assures that Commission rules neither advantage nor disadvantage LECs that wish to participate in the NECA pools. *Id.*

53 *See* ¶ 18, *infra*, for a discussion of "gaming."

54 *LEC Price Cap Order*, 5 FCC Rcd at 6819.

55 *Id.*

develop and influence LEC behavior and earnings, a LEC electing price cap regulation must make a permanent commitment.[56] Finally, our price cap plan included an "all-or-nothing" rule that required a price cap LEC to convert any of its affiliated companies that would otherwise continue to operate on a rate-of-return basis to price cap regulation so that the LEC could not improperly shift costs from a price cap affiliate to a rate-of-return affiliate.[57] Thus, the Commission determined that for price cap incentives to work properly the election of price caps should be irrevocable, price cap regulation should extend to all cost affiliates of the electing LEC, and that price cap incentives were inconsistent with pooling.

15. In the *Small Telco Reform Order*, we stated that our objective in creating the incentive plan was to establish a regulatory alternative to rate-of-return regulation that would adapt the efficiencies and incentives of price caps in a manner applicable to the particular needs of smaller and mid-size LECs.[58] Such regulation would occupy the middle ground on the continuum between rate-of-return and price caps by offering participating LECs more flexibility to meet changing market conditions than would rate-of-return regulation, but at less risk than full price caps.[59]

16. Accordingly, the Commission's optional incentive plan contains mechanisms, absent from baseline rate-of-return regulation, that are designed to encourage companies to become more efficient. We recognize that those mechanisms are not as stringent as the mechanisms that exist in price cap regulation, because under the optional incentive plan a carrier assumes less risk, and consequently may reap fewer rewards than a price cap carrier. In balancing the risks and rewards associated with the optional incentive plan, we offset the increased flexibility that the incentive plan offers participating LECs by designing safeguards to protect the incentive program from potential gaming of the system and weakening of the incentives for increased efficiency.

17. To increase the flexibility in the incentive plan, we eliminated certain price cap protective mechanisms. For example, unlike the decision to elect price caps, the decision to elect incentive plan regulation may be revoked. Further, although we imposed a form of "all-or-nothing" participation for the incentive plan by requiring that all cost-based affiliates of a LEC

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[56] *Id.* There are other circumstances as well, where the Commission has prohibited LECs from shifting in and out of a regulatory regime out of concerns for potential "gaming." *See e.g.* In re National Exchange Carrier Association, Inc. Revision of Section 69.605 of the Commission's Rules to Allow Small Cost Settlement Companies to Elect Average Schedule Settlement Status, *Order*, AAD 96-122, DA 96-2008 (December 2, 1996).

[57] *Id.*

[58] *Small Telco Reform Order*, 8 FCC Rcd at 4547.

[59] *Id.*

elect the plan,[60] we also allowed a participant to elect the plan solely for its traffic sensitive rates, while continuing to tariff its common line rates through the NECA pools. To safeguard the plan against gaming, we required a LEC to participate in the incentive plan for at least two consecutive tariff periods, and to give at least two years' notice prior to leaving the incentive plan. We also barred LECs exiting the incentive plan from reentering the plan for four years (two tariff periods) after that exit. In addition, while our rules permit carriers to exit incentive regulation, they do not permit carriers to return to the NECA pools.[61] These conditions are less stringent than price cap requirements, but more restrictive than the requirements associated with baseline rate-of-return regulation.

18. Two year notice period. We reaffirm our decision to require a reasonable notice period from LECs that wish to leave the incentive plan, but conclude that notice given at least ninety days before leaving the plan would satisfy this requirement. In establishing our optional incentive plan, although we allowed carriers to leave the incentive plan and return to baseline rate-of-return regulation, we acknowledged that this option potentially could permit LECs to game the system. Specifically, a carrier participating in the incentive plan bases its rates on its historical costs. The carrier is rewarded for lowering its costs below its historical costs because it is allowed to retain earnings generated during the tariff period that exceed the carrier's authorized rate of return. The incentive plan assumes that this greater earnings potential would cause participants to invest efficiently to modernize their network in order to reduce their cost of providing service in the future. Such cost savings, all other things being equal, would produce in future periods higher earnings for the LEC and ultimately lower rates for the customer. Baseline rate-of-return regulation, on the other hand, is a prospective, cost-based system in which the carrier projects its costs and demand to develop its rates. Without proper safeguards in place, a LEC participating in the incentive plan could seek to maximize its profits by deferring modernization of its network infrastructure during an incentive plan tariff period in order to minimize short-term costs, and then withdrawing from the plan at the end of that tariff period. The LEC could then invest in new network facilities under rate-of-return regulation and add those costs to its projected cost of service for the upcoming tariff year. By switching between regulatory schemes in this way, the LEC could improperly increase its earnings under the incentive plan and also recoup its costs by raising rates under rate-of-return. As noted above, the safeguards contained in the incentive plan were designed to prevent such short-term schemes because they would eliminate the benefits to consumers of the incentive plan and virtually ensure that rates would not decrease.

19. To safeguard against this type of gaming, we required participants to remain in the program for a minimum of two tariff periods and also to give a two year notice of intent to leave

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[60] *See* 47 C.F.R. § 61.50(b).

[61] *See* 47 C.F.R. § 61.50(d).

cost-of-service rates to ensure that the LEC was not gaming the system, as described in paragraph 18, above. Such an examination would not be possible if the carrier returned to the NECA pool because NECA pool members, unlike other rate-of-return LECs, do not file cost projections with the Commission. Instead, NECA pool members file these projections with NECA, which in turn projects the total cost and demand of its members for the upcoming tariff period and files this aggregate cost data with the Commission for review. We believe that allowing pool reentry under these circumstances poses an unnecessary risk for the ratepayer. For this reason, we will need to review the required cost projections and cost of service studies to determine whether the LEC has improperly shifted its costs, or is intending to do so. Thus, we decline to allow incentive plan participants to reenter the pools as requested by USTA and NECA.

### 2. Pricing Flexibility

*Background*

22. The optional incentive plan created a system of service baskets and categories identical to the system we adopted for price cap LECs.[63] The incentive plan also requires that within each two-year tariff period aggregate rates for each basket remain unchanged. As in price caps, however, we created a "no suspension zone" that permits carriers to raise or lower rates within each service category by 10% over the two-year period, subject to the same notice and support requirements as similar price cap filings.[64] In the *Small Telco Reform Order*, we also

[63] *See* 47 C.F.R § 61.50(e). This section states that incentive plan LECs shall establish baskets and service categories as identified in Sections 61.42(d) and (e). *See* 47 C.F.R. §§ 61.42(d) and (e) (the rules that establish basket and service categories for price cap LECs). Currently, incentive plan service baskets include common line, traffic sensitive switched interstate access elements, trunking services, and an interexchange service basket if the LEC provides such services. *See* 47 C.F.R. § 61.42(d). The traffic sensitive switched interstate access basket contains the following services: local switching; information; data base access services; and billing name and address. The trunking basket contains the following service categories and subcategories: voice grade entrance facilities; voice grade direct-trunked transport; voice grade dedicated signalling transport; voice grade special access; WATS special access; metallic special access; and telegraph special access services; audio and video services; high capacity flat-rated transport; high capacity special access; and DDS services (including service subcategories for DS1 and DS3 services); wideband data and wideband analog services; tandem-switched transport; interconnection charges; and signalling for tandem switching. *See* 47 C.F.R. § 61.42(e). We note that over the past two years, the price cap plan has undergone significant modification not reflected in the *Small Telco Reform Order*. For example, when the Commission first adopted the incentive plan, trunking services, (47 C.F.R. § 61.42(e)(2)), were part of the traffic sensitive basket. By tracking the price cap rules, however, the incentive plan rules concerning baskets and service categories allow the smaller LECs to keep pace with the introduction of new services in a manner that avoids the unnecessary administrative expense and potential for inconsistency that would result from duplicative rulemakings.

[64] *See* 47 C.F.R. § 61.50(h)(2). Above-band filings must be accompanied by supporting materials establishing substantial cause for the proposed rates. Below-band filings must be accompanied by supporting materials establishing that the rates cover the service category's cost. *See Small Telco Reform Order*, 8 FCC Rcd at 4550.

cost-of-service rates to ensure that the LEC was not gaming the system, as described in paragraph 18, above. Such an examination would not be possible if the carrier returned to the NECA pool because NECA pool members, unlike other rate-of-return LECs, do not file cost projections with the Commission. Instead, NECA pool members file these projections with NECA, which in turn projects the total cost and demand of its members for the upcoming tariff period and files this aggregate cost data with the Commission for review. We believe that allowing pool reentry under these circumstances poses an unnecessary risk for the ratepayer. For this reason, we will need to review the required cost projections and cost of service studies to determine whether the LEC has improperly shifted its costs, or is intending to do so. Thus, we decline to allow incentive plan participants to reenter the pools as requested by USTA and NECA.

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[63] *See* 47 C.F.R § 61.50(e). This section states that incentive plan LECs shall establish baskets and service categories as identified in Sections 61.42(d) and (e). *See* 47 C.F.R. §§ 61.42(d) and (e) (the rules that establish basket and service categories for price cap LECs). Currently, incentive plan service baskets include common line, traffic sensitive switched interstate access elements, trunking services, and an interexchange service basket if the LEC provides such services. *See* 47 C.F.R. § 61.42(d). The traffic sensitive switched interstate access basket contains the following services: local switching; information; data base access services; and billing name and address. The trunking basket contains the following service categories and subcategories: voice grade entrance facilities; voice grade direct-trunked transport; voice grade dedicated signalling transport; voice grade special access; WATS special access; metallic special access; and telegraph special access services; audio and video services; high capacity flat-rated transport; high capacity special access; and DDS services (including service subcategories for DS1 and DS3 services); wideband data and wideband analog services; tandem-switched transport; interconnection charges; and signalling for tandem switching. *See* 47 C.F.R. § 61.42(e). We note that over the past two years, the price cap plan has undergone significant modification not reflected in the *Small Telco Reform Order*. For example, when the Commission first adopted the incentive plan, trunking services, (47 C.F.R. § 61.42(e)(2)), were part of the traffic sensitive basket. By tracking the price cap rules, however, the incentive plan rules concerning baskets and service categories allow the smaller LECs to keep pace with the introduction of new services in a manner that avoids the unnecessary administrative expense and potential for inconsistency that would result from duplicative rulemakings.

[64] *See* 47 C.F.R. § 61.50(h)(2). Above-band filings must be accompanied by supporting materials establishing substantial cause for the proposed rates. Below-band filings must be accompanied by supporting materials establishing that the rates cover the service category's cost. *See Small Telco Reform Order*, 8 FCC Rcd at 4550.

concluded that this pricing flexibility should be cumulative. By this we mean that the flexed rate (*i.e.*, the rate charged after being raised or lowered within the no suspension zone) in effect at the end of a tariff period should be used to set rates at the beginning of the next tariff period. By using the flexed rate as the historical base for the upcoming tariff period there would be a smooth transition from the rate "flexing" during the prior tariff period to the retargeting of rates to the authorized rate of return for the subsequent tariff period. If rates were not retargeted based on the flexed rate from a prior tariff period, the *Small Telco Reform Order* reasoned that carriers would not have the opportunity to address changing market conditions and to move to more efficient pricing.[65]

23. While we adopted the same price cap baskets and service categories used in price cap regulation,[66] we did not mandate use of indexes to track carrier prices within each basket's service categories.[67] Instead, we required the aggregate rates in each service basket to be based on the aggregate revenues in that basket at the beginning of each tariff period. Aggregate prices for a particular service category within a basket, however, can decrease or increase by a maximum of 10% during the two years between rate filings. The *Small Telco Reform Order* stated that the method of tracking prices would be determined in the tariff review process.[68]

*Positions of the Parties*

24. AT&T argues that Section 61.50(h)(2)[69] could be interpreted to permit an optional incentive plan participant to adjust aggregate basket rates to recover 110% of its costs. AT&T asserts that the rule should state that service category pricing flexibility should differ no more than 10% from the initial rate for that service category during a particular tariff period, and that aggregate basket rates may not rise above the level set at their previous biennial filing.[70] AT&T further asserts that we should adopt a "numerical mechanism" within the optional incentive rate structure to ensure that price changes during the tariff period are neutral or negative for the overall basket revenues (*i.e.*, that the effect of a flexed rate within any particular service category

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65 *Small Telco Reform Order*, 8 FCC Rcd at 4551.

66 *See* n.65, *supra*.

67 *Small Telco Reform Order*, 8 FCC Rcd at 4550.

68 *Id.* at 4550-51.

69 *See* 47 C.F.R. §61.50(h)(2).

70 AT&T Petition at 7-8; *accord* USTA Comments at 3.

would not cause overall basket revenues to rise), and to ensure that service category rate changes comply with the 10% restriction for the tariff period.[71]

*Discussion*

25. The Commission, in the *Small Telco Reform Order*, did not relieve the carrier of its responsibility for tracking its compliance with the limits imposed on its pricing flexibility. Although the Commission declined to specify a particular methodology for tracking rates, it delegated determination of the proper tracking method to the tariff review process. Furthermore, although the optional incentive plan does not require indexes for service categories, the plan does require carriers to calculate an index for each basket affected by rate changes.[72] The plan also contains a self-correcting mechanism that limits a LEC's earnings to no more than 1.5% above the authorized rate of return.[73] By decreasing a LEC's potential for using its pricing flexibility under the optional incentive plan to increase its earnings to levels that far exceed its authorized interstate rate of return, the incentive plan reduces the incentive of a LEC to recover amounts in excess of costs. Finally, under the incentive plan, rates are retargeted to the authorized rate of return at the beginning of each tariff period. Our ongoing experience in implementing the optional incentive plan indicates that the tariff process is an effective tool for tracking pricing flexibility.[74] As we intended, the optional incentive plan protects customers from the types of abuses suggested by AT&T by returning excess earnings to ratepayers in the form of reduced rates in the subsequent tariff period. We therefore decline to amend the optional incentive plan rules for pricing flexibility as requested by AT&T.

### 3. Streamlined Regulation for the Introduction of New Services

*Background*

26. Most carriers eligible to participate in the incentive plan serve areas contiguous to the service areas of one or more price cap LECs, many of which have introduced a number of new services in recent years.[75] The offering of such services by a price cap LEC puts competitive

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[71] AT&T Petition at 8 n.6.

[72] *See* 47 C.F.R. § 61.50(h)(1).

[73] *See* 47 C.F.R. § 61.50(j).

[74] As a part of its supporting data, Cincinnati includes indexing and tracking information covering all rates, including those that were flexed during the tariff period. *See* Cincinnati Bell Telephone Transmittal No. 681, FCC Tariff No. 35, filed April 20, 1995 (1995 access tariff filing).

[75] *See Small Telco Reform NPRM*, 7 FCC Rcd at 5026.

pressure on a smaller LEC in an adjacent area to offer the same services. We believed that requiring incentive plan LECs to supply full cost support for new services like those offered by an adjacent price cap LEC was inconsistent with our objectives of simplification and reducing regulatory burdens.[76] Thus, the *Small Telco Reform Order* allows carriers electing the optional incentive plan or the small company rules to introduce any new service on a streamlined basis, regardless of potential revenues it may generate, so long as the price of the new service is at or below that of an adjacent price cap LEC. A new service that is not like a neighboring price cap LEC's service is not eligible for streamlined review, and must be supported by prospective cost data, as required by Section 61.38 of the Commission's rules.[77] Under the streamlined review process, transmittals introducing new services that are identical to those offered by an adjacent price cap LEC are presumed lawful, require no cost support, and can be filed on 14 days' notice. In place of cost support, the carrier must attach a brief explanation of why the service is like an existing service offered by the adjacent price cap LEC, and an explanation or statement that the price is no higher than the price charged by the neighboring LEC.[78]

27. The Commission designed the incentive plan and the small company rules to provide an administratively simple means of permitting small and mid-size LECs to introduce new services and compete with neighboring price cap LECs for customers. We sought to enable small and mid-size LECs to introduce new services quickly, as well as to stimulate the development of new, innovative service offerings, and to have those services made available to the public as quickly as possible.[79]

*Positions of the Parties*

28. USTA asks the Commission to permit new service introduction on a streamlined basis even if the service is not offered by a neighboring price cap LEC, as long as the price for the new service is no higher than the price charged by the geographically closest price cap carrier that offers a like service. USTA argues that there may be occasions where a carrier would like to introduce a new service, but the service is not offered by a neighboring price cap LEC, or the carrier is not adjacent to a price cap carrier that offers the service. USTA asserts that by not

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[76] *Id.*

[77] *See* 47 C.F.R. § 61.38.

[78] The presumption of lawfulness can be overcome with a showing that the rate filed is greater than an adjacent price cap LEC's rate, or a persuasive argument that the service is not "like." *See Small Telco Reform Order*, 8 FCC Rcd at 4557, n. 110.

[79] *See* 47 U.S.C. § 157.

extending streamlined treatment to such situations, the Commission has imposed unnecessary burdens on LECs that could frustrate their offering of new services.[80]

*Discussion*

29. We find USTA's request to modify the new service provisions of the incentive plan rules unpersuasive. The incentive plan's policy of minimizing administrative costs may justify streamlined cost support for a new service offered by a neighboring price cap LEC where information about one LEC's new services may spill over to customers of the adjacent LEC (*e.g.*, through community-wide marketing efforts throughout the area) and drive demand for new services in both companies. Where the new service is not offered by a neighboring price cap LEC, however, there may not be such exchange of information about new services and thus there is no competitive justification for streamlined treatment. Further, while it may be more burdensome to prepare prospective cost support for a new service offering than simply to mirror another carrier's rates, we are not convinced that the burden of cost justification alone will impede new service offerings. Therefore, we will not modify our rules concerning streamlined treatment of new service offerings as requested by USTA.

30. We note that while Section 61.50(g)[81] specifies the streamlined filing procedures by which an incentive plan LEC may introduce a new service identical to that offered by a neighboring price cap LEC, the rules do not state the *Small Telco Reform Order*'s requirement that all other new service filings be made pursuant to the requirements of Section 61.38 of the rules.[82] We therefore on our own motion revise the rule to reflect this requirement.

### 4. Infrastructure Reporting Requirement for Optional Incentive Plan

*Background*

31. In the *Small Telco Reform NPRM* we stated our belief that the incentive plan, like price caps, would encourage companies to modernize their networks, resulting in greater efficiency, yielding lower costs and increased demand.[83] On the other hand, we were concerned that a company may simply pursue the most cost effective means to accomplish a task to the

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80 USTA Petition at 13.

81 47 C.F.R. § 61.50(g).

82 47 C.F.R. § 61.38.

83 *See Small Telco Reform Order*, 8 FCC Rcd at 4558.

detriment of service quality and investment in network infrastructure.[84] Such a course of action would potentially yield higher earnings for the company but could have a negative impact on the ratepayers in the form of inferior service quality.[85] We concluded that it would serve the public interest to monitor infrastructure developments annually and that the requirement of annual reports would not be burdensome even for the smaller carriers. Therefore, incentive plan carriers were required to file annual infrastructure reports in the same manner as price cap LECs.[86]

*Positions of the Parties*

32. USTA states that under price caps only the LECs required to comply with the Commission's price cap rules must file infrastructure reports, whereas LECs electing price cap regulation are exempt from this reporting requirement.[87] USTA points out that in the *LEC Price Cap Order*, the Commission stated that it was less concerned with reporting from LECs electing price cap regulation because infrastructure reporting from the eight largest LECs would provide a good indication of the state of the nation's telecommunications infrastructure, and that the Commission was reluctant to impose reporting requirements that might be more burdensome for smaller carriers, and thus might preclude their participation in price caps. USTA argues that because the Commission has given no rationale for treating incentive plan LECs differently from similarly sized voluntary price cap LECs, it is arbitrary to require incentive plan LECs to file these reports. USTA asks that the infrastructure reporting requirement for incentive plan participants be eliminated.[88]

*Discussion*

33. We disagree with USTA's contention that our decision in the *Price Cap Order* not to require infrastructure reports from voluntary price cap LECs compels a similar decision for LECs operating under incentive regulation. First, in the *LEC Price Cap Order*, the Commission

[84] *See Small Telco Reform NPRM*, 7 FCC Rcd at 5026.

[85] *Id.*

[86] *Small Telco Reform Order*, 8 FCC Rcd at 4558. Price cap LECs are required to file their service quality and infrastructure reports in the form prescribed by the Automated Reporting Management Information System (ARMIS). *See* Automated Reporting Requirements for Certain Class A and Tier One Telephone Companies, CC Docket No. 86-182, Report and Order, 2 FCC Rcd 5770 (1987), *modified on recon.*, 3 FCC Rcd 6375 (1988). The annual infrastructure report, ARMIS Form 43-07, provides information relating to switching, transmission facilities, LEC call set-up time, access lines in service, access line gain and total capital expenditures. *See Price Cap Performance Review*, 10 FCC Rcd at 9117-18.

[87] USTA Petition at 11, citing the *LEC Price Cap Order*, 5 FCC Rcd at 6829 n.479.

[88] USTA Petition at 11-12.

stated that it reserved the right to revisit the issue of whether to require infrastructure reports from elective price cap LECs,[89] and delegated to the Common Carrier Bureau (Bureau) the responsibility for implementing such service quality and infrastructure reporting requirements.[90] Shortly after the *LEC Price Cap Order* was released, the Bureau released the *Service Quality Modification Order*.[91] In that Order, the Bureau suggested that it might be fruitful to require service quality and infrastructure reports from those LECs that elected price cap regulation.[92] Further, in the *Price Cap Performance Review*, we noted that the Commission is currently reviewing several deferred service quality and infrastructure reporting issues, including the issue of whether LECS electing to operate under price caps should file infrastructure reports.[93] We believe that, as a procedural matter, it would be premature to modify the infrastructure reporting requirements for incentive plan LECs until the Commission has addressed service quality and infrastructure reporting requirements for mandatory and elective price cap carriers in a comprehensive fashion. Finally, in the Universal Service Joint Board Recommended Decision[94] the Joint Board recommended that the Commission incorporate current reporting requirements into the Universal Service review process.[95] Moreover, it is consistent with the Joint Board's recommendation that "the Commission, to the extent possible, rely on existing data to monitor service quality"[96] to leave in place this reporting requirement fashioned to help ensure that "quality service" is being provided by incentive plan LECs.[97] Therefore, we will not alter this reporting requirement at this time, but note that we may revisit the need for the requirement in light of any decisions that we make in a comprehensive review of service quality and infrastructure reporting requirements or in the Universal Service proceeding.

89 *LEC Price Cap Order*, 5 FCC Rcd at 6829 n.479.

90 *Id.*

91 Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Memorandum Opinion and Order, 8 FCC Rcd 7474 (1993) (*Service Quality Modification Order*), *applications for rev. pending.*

92 *Id.* at 7476.

93 *See Price Cap Performance Review*, 10 FCC Rcd at 9121 n.697.

94 Federal-State Joint Board on Universal Service, Recommended Decision, CC Docket No. 96-45, FCC 96-3 (rel. Nov. 8, 1996), (Recommended Decision).

95 *Id.* ¶ 105.

96 *Id.*

97 Further, we do not believe that an annual infrastructure reporting requirement is an undue burden to incentive plan LECs. Cincinnati Bell, the only current incentive plan LEC, is up-to-date in its filing of both the service quality (ARMIS 43-05) and infrastructure (ARMIS 43-07) reports. They have filed all reports covering year-end 1995 data. New reports for year-end 1996 are not due to be filed until April 1997.

## B. Issues for Clarification

### 1. Carrier Common Line Demand Adjustment Formula

*Background*

34. As we noted in the *Small Telco Reform NPRM*, adapting the small company rules to carrier common line (CCL)[98] rates in a manner that would achieve genuine rate neutrality[99] presented a more complicated problem than did the creation of the initial small company rules, which applied solely to traffic sensitive rates.[100] Although the actual costs of the common line loops are not traffic sensitive, *i.e.*, the cost of the loop does not vary with the number or duration of the calls originating or terminating in the loop, the costs are nonetheless recovered in part through per minute charges.[101] Specifically, LECs recover their common line costs through both carrier common line rates charged on a per minute basis to interexchange carriers, and subscriber line charge rates charged on a per line basis to subscribers.[102] We believed that calculating proper rates for each of these elements would be more complicated than it had been for traffic sensitive rates.[103] Further, given the essentially fixed nature of common line costs, growth in the usage minutes of the common line loops would continually drive future unit costs below historical unit costs.[104] The question of where to allocate the value that would result from this growth, *i.e.*, the "benefit of demand growth," has engendered significant comment in this proceeding.

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[98] A LEC's common lines are loops linking the end-user's premises with the LEC office.

[99] The *Small Companies Order* defines "rate neutrality" as that which ensures that access rates are not unreasonably high. 2 FCC Rcd at 3811.

[100] *Small Telco Reform NPRM*, 7 FCC Rcd at 5028.

[101] *Small Telco Reform Order*, 8 FCC Rcd at 4554.

[102] *Id.* Also, the Universal Service Joint Board in the Recommended Decision concluded that the usage-sensitive CCL charge constituted an economically inefficient mechanism for recovering non-traffic sensitive loop costs, and urged the Commission to change the current CCL rate structure so that LECs are no longer required to recover the non-traffic sensitive cost of the loop from IXCs on a traffic-sensitive basis. *See* Recommended Decision, *supra* n. 95, at ¶ 754.

[103] *Small Telco Reform NPRM*, 7 FCC Rcd at 5028.

[104] *Id.*

35. In the *Small Telco Reform NPRM* we proposed to derive rates for the optional incentive plan and the small company rules by using costs from the most recent 12-month period.[105] To compute demand, the company would determine the average carrier common line usage and the percentage growth in usage over the most recent 24-month period. Thus, a simple extrapolation of base period demand, increased by base period growth (expressed as a percentage of base period demand), would provide the demand for the rate period. We stated in the *Small Telco Reform NPRM* that this methodology is consistent with the baseline rate-of-return practice in which ratepayers receive the benefits of projected demand growth in the form of lower rates. The proposed methodology differed from baseline rate-of-return in that baseline rate-of-return practice permits the use of prospective data, while the incentive plan proposal relied solely on historical cost and demand. Thus, we believed the LEC would have incentives to reduce its costs and stimulate demand growth.[106]

36. Parties commenting on the *NPRM* urged the Commission to credit the participating LEC with the growth in interstate line demand by splitting the benefit of demand growth between the LEC and its interstate access customers, as is done for common line demand growth in areas served by price cap LECs.[107] As proposed, the benefit of the revenue from increased minutes of use would be shared between the customer and the LEC, so the customer receives lower rates and the participating LEC receives increased earnings. In the *Small Telco Reform Order*, we found that permitting LECs to share in the benefit of demand growth with customers by retaining some extra earnings would give the LECs an additional incentive for greater efficiency.[108] The Commission thus decided to adopt a common line rate formula that computed demand for the rate period by using one-half the growth of common line minutes of use during the 24-month historic period, effectively crediting the LECs with half of the historical demand growth.[109]

37. Both USTA and AT&T argue that the common line demand formula adopted in the rules accompanying the *Small Telco Reform Order* is inconsistent with the intent expressed

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[105] *Id.* at 5025, 5028. In the case of Section 61.39 carriers that settle on the average schedules, we proposed the use of the LEC's most recent common line settlements through the average schedules. *Id.*

[106] *Small Telco Reform Order*, 8 FCC Rcd at 4559.

[107] *See* 47 C.F.R. § 61.46(d). Price cap LECs are credited with at least 50 percent of the benefit of demand growth.

[108] In the *LEC Price Cap Order* we recognized that, although common line demand growth is largely outside the LECs' influence and control, LECs nonetheless have some ability to encourage common line growth and to reduce costs. We thus adopted a 50-50 approach to credit the price cap LEC with a portion of demand growth. *See LEC Price Cap Order*, 5 FCC Rcd at 6794. Similarly, in the *Small Telco Reform Order* we found that by applying the 50-50 approach to the incentive plan, we could credit participating LECs with a portion of common line demand growth and thus give them further incentives to reduce costs and increase demand. 8 FCC Rcd at 4554.

[109] *Small Telco Reform Order*, 8 FCC Rcd at 4554.

by the language of the order because it does not provide for sharing the benefit of demand growth.[110]

*Discussion*

38. We believe that the rules for determining demand growth for common line minutes for both the optional incentive plan and for the small company rules reflect the Commission's decision as expressed by the text of the *Small Telco Reform Order*. We are concerned, however, that the petitioners' perception of a discrepancy between the text of the order and the rule may lead to inconsistencies in the manner in which participating LECs apply the common line rate rules. We have therefore redrafted the rules for determining demand growth as formulae. We believe that by drafting the rules as formulae, we have clarified the method carriers are to use in calculating carrier common line rates. The formulae are included in Appendix A.

### 2. Clarification of the "Heavy Burden" Test

*Background*

39. The *Small Telco Reform Order* permits an incentive plan LEC to raise rates if after the first year of a two-year tariff period the LEC shows in a tariff filing that its rates under incentive regulation have fallen below a zone of reasonableness, and that this trend is likely to continue through the remainder of the two-year rate period.[111] To preserve the plan's incentives, the *Small Telco Reform Order* states that we would consider requests for mid-term rate increases only if the LEC's earnings have fallen more than 0.75% below the prescribed rate of return and that we would permit rate increases only to the extent necessary to allow the LEC's earnings to rise to that same level (*i.e.*, 0.75% below the prescribed rate of return) during the second year of the rate period.[112]

40. The *Small Telco Reform Order* also would permit LECs subject to the incentive plan to request mid-term rate adjustments targeted to the authorized rate of return if the LEC can show that rates are otherwise confiscatory. In this circumstance, the order requires the LEC to demonstrate that the optional incentive plan, including the lower rate adjustment, precludes it

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[110] AT&T Petition at 5-6; USTA Petition at 17-18; USTA Comments at 2-3. *See* 47 C.F.R. § 61.39(b)(3) and (4); 47 C.F.R. § 61.50(k).

[111] *Small Telco Reform Order*, 8 FCC Rcd at 4548; 47 C.F.R. § 61.50(j).

[112] Small Telco Reform Order, 8 FCC Rcd at 4548.

from setting reasonable rates. These latter filings would be subject to special scrutiny with a high probability of suspension and investigation.[113]

41. USTA argues that language elsewhere in the *Small Telco Reform Order* clouds the distinction between mid-course corrections to the lower earnings limit, and mid-course rate adjustments designed to yield the authorized rate of return.[114] For example, USTA states that in the section that addresses the earnings band, the Commission states that it is "imposing a burden of proof that rates are unreasonable for mid-term corrections" without distinguishing between the types of mid-term corrections.[115] Similarly, USTA contends that paragraph 56 of the *Small Telco Reform Order* states that the Commission has "established a higher burden for mid-term filings," again without distinguishing between adjustments to the lower end of the earnings band and adjustments to the authorized rate of return.[116] In its petition, USTA asks for a clarifying statement that the "heavy" or "higher" burden applies only to mid-course filings adjusting rates to the prescribed rate of return, and does not apply to mid-term filings intended to yield a return at the lower earnings limit of the optional incentive plan.[117]

*Discussion*

42. Under the incentive plan, both types of mid-term filings carry a burden greater than that of the biennial filing. Between the two types of mid-course filings -- those seeking to achieve earnings at the lower end of the earnings band, and those seeking to achieve the authorized rate of return -- the latter bears a higher burden, carrying with it a likelihood of suspension and investigation. We find the language of the *Small Telco Reform Order* to be clear and consistent on this point, and thus find no reason to provide the clarification USTA seeks.

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113 *Id.*

114 USTA Petition at 14-15.

115 *Id.* at 15.

116 *Id.*

117 *Id.*

### 3. Exogenous Cost Treatment

*Background*

43. The *Small Telco Reform Order* states that LECs under the optional incentive plan can claim exogenous costs, as defined by our rules,[118] either in their biennial filing or at the time the event causing the cost change occurs during the two-year rate period.[119] USTA argues that the Commission should codify the allowance of exogenous costs. For this purpose, USTA proposes the following language:

> Local exchange carriers subject to this section shall file, either at the beginning of or during the biennial tariff period, tariff revisions that reflect the impact on rates resulting from exogenous cost changes as defined in § 61.45 (d)(1).[120]

*Discussion*

44. The optional incentive plan permits carriers to adjust rates during the tariff period for costs that are deemed exogenous for price cap LECs.[121] We agree with USTA that our rules should be amended to state explicitly that carriers subject to the optional incentive plan may file

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118 "Exogenous" costs are defined as those caused by administrative, legislative, or judicial actions beyond the carrier's control and not otherwise reflected in the price cap calculation. *See* 47 C.F.R. § 61.45(d). The Commission found that exogenous costs should result in an adjustment of the price cap formula to ensure that the formula does not lead to unreasonably high or unreasonably low rates. *See LEC Price Cap Order*, 5 FCC Rcd at 6807.

119 *Small Telco Reform Order*, 8 FCC Rcd at 4553.

120 USTA Petition at 17.

121 *Small Telco Reform Order*, 8 FCC Rcd at 4553. Some of these costs, such as adjustments to long term support payments, have been deemed exogenous by rule, *see* 47 C.F.R. § 61.45(d)(1)(iv), while other cost changes require prior action by the Commission before they are eligible for this treatment. For example, as noted recently in the *Price Cap Performance Review*, the Commission has allowed the LECs to treat as exogenous the reasonable costs they incurred specifically to implement and operate the basic 800 data base service required by Commission orders. *See Price Cap Performance Review*, 10 FCC Rcd at 9081 n.513 (citing Provision of Access for 800 Service, Second Report and Order, CC Docket No. 86-10, 8 FCC Rcd 907, 911 (1993) (*Second 800 Service Order*). The Commission reasoned that because it effectively required the LECs to implement this service and dictated the terms, conditions, and schedule under which the LECs had to offer it, the reasonable costs specific to implementing basic 800 data base service were outside the carrier's control and, therefore, could be treated exogenously. *Id.* In that order, however, the Commission strictly limited the costs eligible for exogenous treatment to those costs considered to be specific to the implementation of 800 data base service. Thus, for example, price cap LECs were not allowed to recover core SS7 (advanced signalling network protocol) costs or the costs of accelerating the deployment of SS7 to meet the Commission timetable because those costs were deemed to be neither reasonable nor incurred specifically to implement the 800 database requirement. *See Second 800 Service Order*, 8 FCC Rcd at 911.

revisions to their tariffs to reflect adjustments attributable to exogenous cost changes either in the biennial tariff filing or during the two-year tariff period. The new regulation is included in Appendix A.

### 4. Frequency of Tariff Filings Under Baseline Regulation

*Background*

45. The *Small Telco Reform Order* changed Section 69.3(a) of the Commission's rules to state that "a tariff for access service shall be filed with this Commission for a two-year period."[122] Thus, except for NECA which must file an access tariff each year, LECs subject to baseline rate-of-return regulation must file their tariffs every two years, although more frequent filings are permitted.[123] USTA asks that Section 69.3(a) be modified to make clear that a carrier filing an access tariff under baseline rate-of-return regulation has the option of filing for an annual period.[124]

*Discussion*

46. LECs subject to baseline rate-of-return regulation under Section 61.38 of our rules[125] must revise their access tariffs at least once every two years according to Section 69.3(a) of our rules.[126] In the interest of reducing the administrative burdens for carriers in a manner that still permits the Commission to meet its statutory obligation to assure that rates are reasonable, the *Small Telco Reform Order* changed the rules to require biennial, rather than annual, filings.[127] That order also stated that biennial filings were considered optional[128] to the extent that we would not consider an annual filing to be a mid-course filing.[129] Nothing in our rules prevents rate-of-

[122] *See* 47 C.F.R. § 69.3(a).

[123] The *Small Telco Reform Order* specifically states that annual filings made by baseline rate-of-return regulated carriers would not be considered mid-course filings. *See* 8 FCC Rcd at 4560.

[124] USTA Petition at 18-19.

[125] *See* 47 C.F.R. § 61.38.

[126] *Small Telco Reform Order*, 8 FCC Rcd at 4560; *see also* Cost Support to be Filed With 1995 Access Tariffs, Tariff Review Plans, 10 FCC Rcd 6164, 6174 (1995).

[127] *Small Telco Reform Order*, 8 FCC Rcd at 4560

[128] *Id.*

[129] *Id.*

return LECs from making annual filings if the LEC so chooses. We thus do not find it necessary to amend our rules and deny USTA's request to state in our rule that baseline carriers may file annual access tariffs. We note, however, that while the *Small Telco Reform Order* revised Section 69.3(a) of the rules to allow biennial filings, Section 69.3(b) was not revised to eliminate the reference to "annual" filings. We therefore delete the reference to "annual" tariff filings in Section 69.3(b) so that the section is consistent with permissible biennial filings.

### 5. Base Period for End User Common Line Calculations

47. USTA argues that Section 61.50 does not address how an incentive plan carrier should calculate the end user common line charge. In contrast, USTA asserts, Section 61.39(b)(5) of the small company rules, defines a two-year base period for end user common line calculations.[130] For purposes of clarification, USTA asks that we include the language of Section 61.39 (b)(5) in Section 61.50. We agree with USTA, and make this change to our rules.

### 6. Nonexistent Paragraph Reference

48. USTA asserts that Section 61.50(h)(1) makes an erroneous reference to a paragraph (c)(4).[131] We agree and remove the reference to paragraph (c)(4).

## IV. ORDERING CLAUSES

49. Accordingly, IT IS ORDERED that pursuant to authority contained in Sections 1, 4(i) and (j), 201-205, 218, 220 and 403 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 151, 154(i) and (j), 201-205, 218, 220, and 403, Parts 61 and 69 ARE AMENDED as set forth in Appendix A.

50. IT IS FURTHER ORDERED that the petitions for reconsideration and clarification concerning the regulatory reforms for local exchange carriers subject to rate-of-return regulation ARE DENIED, EXCEPT TO THE EXTENT GRANTED HEREIN.

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[130] USTA Petition at 19-20.

[131] *Id.* at 20.